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Supreme Court, U.S.
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No. 93-249

In the Supreme Court of the United States

OCTOBER TERM, 1993

JAMIEL CHAGRA AND ELIZABETH CHAGRA, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether, in reconstructing the income of taxpayers who have stipulated to cash expenditures in excess of their reported income for the years in question, the Commissioner of Internal Revenue is required to establish the source of their unreported income.

2. Whether petitioners bore the burden of proving that they were entitled to income tax deductions for gambling losses under Section 165(d) of the Internal Revenue Code, 26 U.S.C. 165(d).

3. Whether the court of appeals properly declined review of the March 30, 1992, Tax Court order denying litigation costs when petitioners' notice of appeal specified that they were appealing the July 8, 1992, Tax Court order on the merits of the tax claims involved.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A5) is unpublished, but the judgment is noted at 990 F.2d 1250 (Table). The opinion of the Tax Court is unofficially reported at 60 T.C.M. (RIA) ¶ 91,366 (1991).

JURISDICTION

The judgment of the court of appeals was entered on February 2, 1993. The petition for rehearing was denied on June 9, 1993 (Pet. App. A8-A9). The petition for a writ of certiorari was filed on August 6, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

STATEMENT

1. Petitioner Jamiel Chagra was convicted on drug smuggling and importation charges in 1979 (C.A. App. 5). During the period from 1977 to 1981, petitioner and his wife, Elizabeth Chagra, made cash expenditures in excess of $3,000,000 for petitioner's drug-trafficking activities, the extensive remodeling of their Las Vegas house, the purchase of jewelry, furniture and automobiles, and a $75,000 fee paid for the attempted assassination of an Assistant United States Attorney (*id.* at 6-25). Petitioners failed to maintain books and records reflecting their income for those years (*ibid.*).

On audit of their federal income tax returns for those years,[1] the Commissioner reconstructed petitioners' income for 1977, 1978, 1980, and 1981 on the basis of the source and application of funds method.[2] For the taxable year 1979, petitioners' income was reconstructed using the specific item method.[3] Deficiencies in income tax ($2,638,011) and additions to

[1] Petitioners filed joint federal income tax returns for the years 1978, 1979, 1980, and 1981. Petitioner Jamiel Chagra filed a separate return for 1977.

[2] Under this method, the amount by which the taxpayer's cash expenditures during a taxable period exceed his known sources of income for the period is deemed taxable income unless the taxpayer can show that his expenditures were made from a nontaxable source of funds. *See DeVenney* v. *Commissioner*, 85 T.C. 927, 930-931 (1985).

[3] Under this method, the government produces evidence that the taxpayer received specific items of reportable income that did not appear on the taxpayer's income tax return. *See United States* v. *Horton*, 526 F.2d 884, 886 (5th Cir.), cert. denied, 429 U.S. 820 (1976).

tax for fraud ($1,349,006) were asserted against petitioner Jamiel Chagra for the year 1977 and against petitioners jointly for the years 1978 through 1981 (C.A. App. 3).

Petitioners sought redetermination of these deficiencies in the United States Tax Court. In responsive pleadings, the Commissioner asserted additional deficiencies for the years 1977, 1978, and 1980 in the aggregate amounts of $1,571,638 in income tax and $785,819 in additional fraud penalties (C.A. App. 3).

Pursuant to its order entered on August 6, 1991, the Tax Court determined that petitioners had unreported income in the aggregate amount of $1,297,015 and were liable for deficiencies in tax and additions to tax for fraud for these years in the aggregate amounts of $1,142,821 and $565,478, respectively (C.A. App. 125).

On January 6, 1992, petitioners filed a motion for award of litigation costs under Section 7430 of the Internal Revenue Code. Petitioners asserted that they had substantially prevailed with respect to the amounts in issue for the 1979 tax year (for which the Tax Court had reduced the asserted deficiency from $1,267,118 in tax and $663,559 in addition to tax to $2,883 in tax and no addition to tax) and that the Commissioner's deficiency determination for that year—based on the specific item method of reconstructing income—was arbitrary and not substantially justified.

On March 30, 1992, the Tax Court entered its order denying petitioners' motion for litigation costs. The court held that petitioners "did not prevail with respect to the main issues in this proceeding" and

that the position of the Commissioner was reasonable (C.A. App. 106). The Tax Court stated that (*ibid.*):

> [t]o the extent we ruled for petitioners in this proceeding, those rulings resulted from the resolution of factual issues, the supporting facts of which may not have been fully developed prior to trial. Given the overall factual complexity of this case, we conclude that [the Commissioner's] position herein was reasonable under these circumstances.

The Tax Court entered its final decision on the merits of the deficiencies on July 8, 1992, "[p]ursuant to the opinion of the Court filed August 6, 1991" (C.A. App. 125). In that order on the merits of the case, the court made no reference to its order of March 30, 1992, concerning litigation costs. On September 1, 1992, petitioners filed a notice of appeal from the Tax Court's decision entered July 8, 1992 (*id.* at 127).

2. The court of appeals affirmed (Pet. App. A1-A5). The court held that the Tax Court properly disallowed a deduction for payment of a $915,000 gambling debt in 1978 because gambling losses may only be deducted against gambling income under Section 165(d) of the Code, 26 U.S.C. 165(d). The court noted that "the only evidence of any gambling income in 1978 is the fact that Petitioners, who at the time were receiving large amounts of cash from Jamiel Chagra's drug-trafficking activities, declared $1,521,830 in income from gambling in 1978 on their tax return" (Pet. App. A3).[4] The court rejected peti-

[4] The bare assertion on the return that petitioners received this sum as income from gambling has no weight, for petitioner Jamiel Chagra testified at trial that, on advice of counsel, he

tioners' argument that the Commissioner should have been required to prove a source of income for petitioners' cash expenditures. The court noted that a deficiency determination need only be supported by "rational underpinnings," a requirement satisfied here by the stipulation that petitioners spent more than they reported in income and by the absence of any evidence that they possessed a cash hoard (*id.* at A3-A4). The court concluded that (*id.* at A4):

> there is abundant evidence in the record that Jamiel Chagra was engaged in substantial drug trafficking. It is rational to conclude that he continued to receive income from drug trafficking in 1980 and 1981, despite the fact that he was a fugitive in the first two months of 1980 and was incarcerated thereafter. As the Tax Court noted, Petitioners spent over a million dollars in 1980 and 1981, despite the fact that they did not liquidate assets during those years and did not have any reported source of income.

The court of appeals held that the question whether the Tax Court erred in refusing to award litigation costs to petitioners under 26 U.S.C. 7430 was not properly before it. The court noted that the motion for award of litigation costs was denied by order dated March 30, 1992. Petitioners' notice of appeal, however, specifically referred only to the Tax Court's decision on the merits dated July 8, 1992, and did not mention or incorporate the March 30, 1992, order on litigation costs. The court therefore declined to consider petitioners' contentions concerning the March

included income from drug sales as "gambling" income (Tr. 409-410, 428).

30, 1992, order denying litigation costs (Pet. App. A4-A5).

ARGUMENT

The fact-bound decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. For the 1980 and 1981 tax years, the Commissioner reconstructed taxpayers' income by the source and expenditure of funds method. See note 2, *supra*. The notice of deficiency stated that certain expenditures made by taxpayers during those years could not be traced to nontaxable sources of income or previously reported income and therefore constituted unreported income. Taxpayers stipulated to the expenditures asserted in the notice of deficiency. As the court of appeals stated, "Petitioners stipulated that their cash expenditures exceeded their reported income in 1980-1981. Since there is no evidence that they had a cash hoard, this stipulation supports the inference that they had some amount of unreported income" (Pet. App. A4).[5]

[5] *Llorente* v. *Commissioner*, 649 F.2d 152 (2d Cir. 1981), is not to the contrary. In *Llorente*, the Second Circuit recognized that the danger of a "naked assessment"—a notice of deficiency with no rational underpinning—is that the Commissioner could "place upon the taxpayer the unfair, and at time[s] impossible, burden of proving a negative, that he did not receive the illegal income assessed against him." *Id.* at 156. To protect the taxpayer from a naked assessment, "the evidence of record must at least link the taxpayer with some tax-generating acts." *Ibid.* When a taxpayer admits receipt of cash in excess of reported income, however, there is no danger of a naked assessment and the rational underpinning for a deficiency determination exists. See *Parks* v. *Commissioner*, 94 T.C. 654, 658 (1990);

Contrary to petitioners' contention (Pet. 7), in reaching this conclusion, the court of appeals did not make findings of fact or substitute its own findings for those of the Tax Court. The court of appeals noted that the Tax Court found that petitioners "spent over a million dollars in 1980 and 1981, despite the fact that they did not liquidate assets during those years and did not have any reported source of income" (Pet. App. A4). The inference to be drawn from the Tax Court's finding—that petitioners had unreported income during those years—was drawn by the Tax Court itself in its determination that petitioners were liable for a deficiency in income tax for those years. The court of appeals merely concluded that the findings of the Tax Court were not clearly erroneous.

2. Petitioners assert (Pet. 9) that the court of appeals erred in holding that petitioners had the burden of proving they were entitled to deductions. It is well settled, however, that deductions are a matter of legislative grace and that taxpayers have the burden of establishing their entitlement to deductions. *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934); Tax Ct. R. 142(a). Particularly with respect to the deduction for gambling losses permitted by the Code, Section 165(d) states that "[l]osses

Tokarski v. *Commissioner*, 87 T.C. 74, 76-77 (1986). In this case, the Commissioner's determination was plainly not arbitrary, for it is undisputed that the taxpayers' cash expenditures exceeded their reported income. As the court of appeals noted, "[s]ince there is a rational basis for the inference that [Petitioners had an unreported source of income,] Petitioners have the burden of proving that the amount the Respondent claims was income came from a non-taxable source" (Pet. App. A4).

from wagering transactions shall be allowed only to the extent of the gains from such transactions." 26 U.S.C. 165(d). In order for petitioners to obtain a deduction for wagering losses in the present case, it was thus their burden to prove the amount of income they had received from gambling. Petitioners failed, however, to offer any particularized evidence of the amount of income they received from gambling in that year. See note 4, *supra*.

Petitioners nonetheless contend (Pet. 8-10) that they had no burden of proving their entitlement to this deduction because the Commissioner asserted that the 1978 return was fraudulent. It is true that the Commissioner bears the burden of proving by clear and convincing evidence for each year in issue for which fraud is claimed that some portion of the underpayment was due to fraud. *Traficant* v. *Commissioner*, 884 F.2d 258, 264 (6th Cir. 1989); *Akland* v. *Commissioner*, 767 F.2d 618, 621 (9th Cir. 1985). Petitioners, however, confuse the government's burden of establishing fraud with their own burden under Section 165(d) of the Code to demonstrate that they had sufficient gambling income to *permit* a deduction for the $915,000 gambling debt paid in 1978. Once the Commissioner has established a prima facie case that the taxpayer has asserted a baseless deduction (see note 4, *supra*), the burden of going forward with evidence to the contrary shifts to the taxpayers. See *Papineau* v. *Commissioner*, 28 T.C. 54, 57 (1957).

3. The court of appeals correctly concluded that petitioners had failed properly to appeal the Tax Court's denial of their request for litigation costs (Pet. App. A4-A5). As the court noted, the notice of appeal seeks only "an appeal from the Tax Court's

decision of July 8, 1992," concerning the merits of the tax dispute (*id.* at A4). The notice of appeal makes no reference to the March 30, 1992, order denying their motion for litigation costs. See C.A. App. 127. And, the July 8, 1992, order does not mention or incorporate the March 30, 1992, order.

Rule 3(c) of the Federal Rules of Appellate Procedure requires the notice of appeal to "designate the judgment, order or part thereof appealed from" (Fed. R. App. P. 3(c)). If a party does not satisfy the requirements of Rule 3, then the appellate court does not acquire jurisdiction over the undesignated issues. *Torres* v. *Oakland Scavenger Co.*, 487 U.S. 312, 317 (1988) ("although a court may construe the Rules liberally in determining whether they have been complied with, it may not waive the jurisdictional requirements of Rules 3 and 4"). The courts have therefore held that, when an appeal is taken from a specified judgment or order, the appellate court acquires no jurisdiction over other judgments or orders not specified, or fairly encompassed, within the notice of appeal. See, *e.g.*, *Mariani-Giron* v. *Acevedo-Ruiz*, 945 F.2d 1, 3 (1st Cir. 1991); *Wilson* v. *Firestone Tire & Rubber Co.*, 932 F.2d 510, 516 (6th Cir. 1991); *Lockary* v. *Kayfetz*, 917 F.2d 1150, 1157 (9th Cir. 1990); *United States* v. *Rivera Construction Co.*, 863 F.2d 293, 298-299 (3d Cir. 1988); *Cole* v. *Tuttle*, 540 F.2d 206, 207 (5th Cir. 1976); *Symons* v. *Mueller Co.*, 526 F.2d 13, 19 (10th Cir. 1975). Appellate jurisdiction may exist over orders not specified in the notice of appeal if there is a functional connection between the specified and the unspecified order and the intention to appeal the unspecified order is apparent. That principle, however, "cannot be stretched to create appellate

jurisdiction over entirely collateral orders." *Williams* v. *Guzzardi*, 875 F.2d 46, 49 n.4 (3d Cir. 1989).[6] When an order not specified or referred to in a notice of appeal was not a "step in the procedural progression" of the order or judgment for which a timely notice of appeal has been filed, the issue is not fairly raised and the court of appeals does not acquire jurisdiction over it. *United States* v. *Rivera Construction Co.*, 863 F.2d at 298, quoting *Elfman Motors, Inc.* v. *Chrysler Corp.*, 567 F.2d 1252, 1254 (3d Cir. 1977) (per curiam). See also *Terkildsen* v. *Waters*, 481 F.2d 201, 206 (2d Cir. 1973); 9 *Moore's Federal Practice* ¶ 203.17[2], at 3-78 (2d ed. 1993).

Petitioners err in contending (Pet. 4) that the decision in this case conflicts with the decision of the Third Circuit in *Randazzo* v. *United States*, 751 F.2d 145 (3d Cir. 1984) (per curiam). The question in *Randazzo* was whether the taxpayer could appeal from an order denying litigation costs in a jeopardy assessment proceeding under Section 7429 of the Internal Revenue Code. While an order denying litigation costs is ordinarily "subject to appeal in the same manner as the decision" (26 U.S.C. 7430(f)(1)),[7]

[6] An order denying litigation costs is collateral to an order disposing of the merits of the case. *Budinich* v. *Becton Dickinson & Co.*, 486 U.S. 196, 200-201 (1988).

[7] As petitioners note, Section 7430(e) of the Code, as applicable in this case, provided that an order granting or denying an award of litigation costs in a Tax Court proceeding "shall be incorporated as a part of the decision or judgment in the case and shall be subject to appeal in the same manner as the decision or judgment." 26 U.S.C. 7430(e) (1982). This statute was amended in 1988, as to actions commenced after November 10, 1988, to provide that an order with respect to litigation costs "may be incorporated as a part of the decision or

Section 7429(f) provides that "[a]ny determination made by a court [in connection with the making of the jeopardy assessment] under this section shall be final and conclusive and shall not be reviewed by any other court." 26 U.S.C. 7429(f). In *Randazzo*, the Third Circuit held that, since the determination on the merits of a jeopardy assessment is not appealable under Section 7429(f), the order with respect to an award for reasonable litigation costs in a jeopardy assessment proceeding is also not appealable. 751 F.2d at 146.

The ruling in *Randazzo* has no application to cases, such as the present one, that do not involve non-appealable jeopardy assessment proceedings. The decision on the merits in the present case was clearly appealable. While petitioners *could* have appealed from both the denial of litigation costs and the decision on the merits in this case, they did not do so. See C.A. App. 127. The decision of the court of appeals in this case thus does not conflict with the analysis or the holding of *Randazzo*.

judgment * * * and shall be subject to appeal in the same manner as the decision or judgment." Omnibus Taxpayer Bill of Rights, Pub. L. No. 100-647, Tit. VI, Subtit. J, § 6239(a) and (d), 102 Stat. 3746 (codified at 26 U.S.C. 7430(f)(1)).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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